

CONSOLIDATED FINANCIAL STATEMENTS

Indiana University Health, Inc. and subsidiaries
Years Ended December 31, 2013 and 2012
With Report of Independent Auditors

Ernst & Young LLP



Building a better
working world

Indiana University Health, Inc. and subsidiaries

Consolidated Financial Statements

Years Ended December 31, 2013 and 2012

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Report of Independent Auditors

The Board of Directors
Indiana University Health, Inc. and subsidiaries

We have audited the accompanying consolidated financial statements of Indiana University Health, Inc. and subsidiaries, which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Indiana University Health, Inc. and subsidiaries at December 31, 2013 and 2012, and the consolidated results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

March 27, 2014

Indiana University Health, Inc. and subsidiaries

Consolidated Balance Sheets

(Dollars in Thousands)

	December 31	
	2013	2012
Assets		
Current assets:		
Cash and cash equivalents	\$ 442,672	\$ 611,630
Patient accounts receivable, less allowance for uncollectible accounts of \$270,743 and \$250,604 at 2013 and 2012, respectively	659,402	617,548
Other receivables	126,552	161,947
Prepaid expenses	39,341	39,741
Inventories	75,340	84,341
Current portion of trustee-held funds	114	501
Total current assets	1,343,421	1,515,708
Assets limited as to use:		
Board-designated investment funds and other investments	2,524,831	1,967,308
Donor-restricted investment funds	94,057	94,975
Trustee-held funds for construction and debt service, less current portion	10,242	13,769
Total assets limited as to use, less current portion	2,629,130	2,076,052
Property and equipment:		
Cost of property and equipment in service	5,690,685	5,573,770
Less accumulated depreciation	(3,036,691)	(2,836,763)
	2,653,994	2,737,007
Construction-in-progress	115,053	44,467
Total property and equipment, net	2,769,047	2,781,474
Other assets:		
Equity interest in unconsolidated subsidiaries	44,578	57,819
Interest in net assets of foundations	13,849	12,898
Unamortized bond issuance costs	6,659	7,197
Goodwill, intangibles, and other assets	244,390	224,717
Total other assets	309,476	302,631
Total assets	\$ 7,051,074	\$ 6,675,865

	December 31	
	2013	2012
Liabilities and net assets		
Current liabilities:		
Accounts payable and accrued expenses	\$ 466,772	\$ 380,336
Accrued salaries, wages, and related liabilities	269,641	278,052
Accrued health claims	57,684	55,593
Estimated third-party payor allowances	90,467	107,552
Current portion of long-term debt	116,149	60,853
Total current liabilities	1,000,713	882,386
Noncurrent liabilities:		
Long-term debt, less current portion	1,682,649	1,824,831
Interest rate swaps	139,072	165,923
Accrued pension obligations	23,992	154,480
Accrued medical malpractice claims	61,438	64,642
Other	51,785	53,955
Total noncurrent liabilities	1,958,936	2,263,831
Total liabilities	2,959,649	3,146,217
Net assets:		
Indiana University Health	3,802,631	3,257,945
Noncontrolling interest in subsidiaries	180,680	168,890
Total unrestricted	3,983,311	3,426,835
Temporarily restricted	41,554	36,549
Permanently restricted	66,560	66,264
Total net assets	4,091,425	3,529,648

Total liabilities and net assets	<u>\$ 7,051,074</u>	<u>\$ 6,675,865</u>
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See accompanying notes.

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Operations and Changes in Net Assets

(Dollars in Thousands)

	Year Ended December 31	
	2013	2012
Revenues:		
Patient service revenue (net of contractals and discounts)	\$ 5,228,038	\$ 5,449,405
Provision for uncollectible accounts	(343,136)	(284,883)
Net patient service revenue	4,884,902	5,164,522
Member premium revenue	156,564	150,646
Other revenue	205,416	263,108
Total operating revenues	5,246,882	5,578,276
Expenses:		
Salaries, wages, and benefits	2,635,648	2,596,349
Supplies, drugs, purchased services, and other	1,750,948	1,773,395
Hospital assessment fee	82,442	179,834
Health claims to providers	94,446	96,132
Depreciation and amortization	248,825	266,941
Interest	61,019	64,358
Total operating expenses	4,873,328	4,977,009
Operating income before educational and research support	373,554	601,267
Educational and research support to Indiana University	(50,000)	(52,610)
Total operating income	323,554	548,657
Nonoperating income:		
Investment income, net	191,083	147,902
Gains on interest rate swaps, net	11,379	17,054
Inherent contribution of acquired entities	—	3,062
Gain on sales and acquisitions and other	14,815	2,200
Total nonoperating income	217,277	170,218
Consolidated excess of revenues over expenses	540,831	718,875
Less amounts attributable to noncontrolling interest in subsidiaries	92,846	67,377
Excess of revenues over expenses attributable to Indiana University Health and subsidiaries	447,985	651,498

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Operations and Changes in Net Assets (continued) (Dollars in Thousands)

	December 31, 2013			December 31, 2012		
	Total	Controlling	Noncontrolling	Total	Controlling	Noncontrolling
Unrestricted net assets:						
Excess of revenues over expenses	\$ 540,831	\$ 447,985	\$ 92,846	\$ 718,875	\$ 651,498	\$ 67,377
Change in pension obligations	86,055	86,055	—	(28,226)	(28,226)	—
Contributions for capital expenditures	8,142	8,142	—	14,690	14,690	—
Distributions to noncontrolling interests	(82,838)	—	(82,838)	(56,663)	—	(56,663)
Issuance of noncontrolling interests related to acquisition	—	—	—	13,556	—	13,556
Contributions from noncontrolling interests	—	—	—	2,940	—	2,940
Fair value of initial noncontrolling interests in acquired entities	—	—	—	3,601	—	3,601
Other	4,286	2,504	1,782	(47)	502	(549)
	556,476	544,686	11,790	668,726	638,464	30,262
Temporarily restricted net assets:						
Change in beneficial interest in net assets of foundations	642	642	—	568	568	—
Contributions	4,341	4,341	—	11,275	11,275	—
Investment return	3,252	3,252	—	2,921	2,921	—
Net assets released from restrictions	(3,230)	(3,230)	—	(13,220)	(13,220)	—
	5,005	5,005	—	1,544	1,544	—
Permanently restricted net assets:						
Change in beneficial interest in net assets of foundations	52	52	—	68	68	—
Contributions and other	244	244	—	354	354	—
Investment return	—	—	—	(347)	(347)	—
	296	296	—	75	75	—
Increase in net assets before contributions of net assets of acquired organizations	561,777	549,987	11,790	670,345	640,083	30,262
Contributions of net assets of acquired organizations at April 1, 2012:						
Temporarily restricted net assets of RHI	—	—	—	244	244	—
Increase in net assets	561,777	549,987	11,790	670,589	640,327	30,262
Net assets at beginning of year	3,529,648	3,360,758	168,890	2,859,059	2,720,431	138,628
Net assets at end of year	\$ 4,091,425	\$ 3,910,745	\$ 180,680	\$ 3,529,648	\$ 3,360,758	\$ 168,890

See accompanying notes.

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Cash Flows

(Dollars in Thousands)

	Year Ended December 31	
	2013	2012
Operating activities		
Increase in net assets	\$ 561,777	\$ 670,345
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Change in fair value of interest rate swaps	(26,851)	(32,294)
Change in pension liability	(86,055)	28,226
Income in unconsolidated subsidiaries	(1,145)	(3,603)
Provision for uncollected patient accounts	343,136	284,883
Issuance of noncontrolling interests and step up to fair value related to acquisitions	—	(17,157)
Contributions from noncontrolling interests	—	(2,940)
Inherent contribution of acquired entities	—	(3,062)
Gain on consolidation of acquired entities	—	(2,200)
Gain on sale of clinics	(12,734)	—
Impairment of unconsolidated subsidiaries	10,134	—
Depreciation and amortization	248,825	266,941
Amortization of deferred gain on sale of medical office buildings	(2,216)	(2,279)
Restricted contributions and investment return	(8,531)	(14,839)
Distributions to noncontrolling interests	82,838	56,663
Trading securities	(552,691)	(388,975)
Net changes in operating assets and liabilities:		
Patient accounts receivable	(384,990)	(325,917)
Other assets	26,635	(52,772)
Accounts payable and accrued liabilities and other liabilities	40,936	18,219
Salaries, wages, and related liabilities	(8,411)	51,797
Estimated third-party payor allowances	(17,085)	20,407
Net cash provided by operating activities	213,572	551,443

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Cash Flows (continued)

(Dollars in Thousands)

	Year Ended December 31	
	2013	2012
Investing activities		
Acquisition of subsidiaries, net of cash received	\$ —	\$ 5,509
Proceeds from sale of clinics	13,050	—
Purchase of property and equipment, net of disposals	(245,792)	(218,107)
Net cash used in investing activities	(232,742)	(212,598)
Financing activities		
Increase in restricted net assets	8,531	14,839
Repayments on long-term debt	(78,484)	(66,696)
Proceeds from issuance of long-term debt	3,003	—
Repayments on notes payable under line of credit, net of proceeds	—	(24,721)
Contributions from noncontrolling interests	—	2,940
Distributions to noncontrolling interests	(82,838)	(56,663)
Net cash used in financing activities	(149,788)	(130,301)
(Decrease) increase in cash and cash equivalents	(168,958)	208,544
Cash and cash equivalents at beginning of year	611,630	403,086
Cash and cash equivalents at end of year	<u>\$ 442,672</u>	<u>\$ 611,630</u>

See accompanying notes.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (Thousands of Dollars)

December 31, 2013 and 2012

Mission Statement

The mission of Indiana University Health is to improve the health of our patients and community through innovation and excellence in care, education, research, and service.

Indiana University Health will preserve, strengthen, and build upon these values:

*A patient's **total care**, including mind, body, and spirit*

*Excellence in **education** for health care providers*

*Quality of care and **respect** for life*

***Charity**, equality and justice in health care*

*Leadership in health promotion and **wellness***

*Excellence in **research***

*An internal community of **trust** and respect*

1. Organization and Nature of Operations

History and Organization

Indiana University Health, Inc. (Indiana University Health) and subsidiaries operate as a health care delivery system, which includes an academic health center affiliated with Indiana University, providing health care services throughout the state of Indiana. Health care services provided by Indiana University Health and its subsidiaries (hereinafter referred to as the Indiana University Health System) include acute, nonacute, tertiary, and quaternary care services on an inpatient, outpatient, and emergency basis; medical education and research; medical management services; health care diagnostic and treatment services for individuals and families in physician clinics and physician-group practices; and personal and home health care.

Indiana University Health was formed as an Indiana nonprofit corporation through a consolidation, as of January 1, 1997, under the terms of a Definitive Health Care Resources Consolidation Agreement, as amended (the Consolidation Agreement), and certain other related agreements by and between the Trustees of Indiana University and Methodist Health Group, Inc. (successor to Methodist Hospital). The facilities and operations of Indiana University Health University Hospital (University Hospital), Riley Hospital for Children of Indiana University Health (Riley Hospital), and Indiana University Health Methodist Hospital (Methodist Hospital) (collectively, the Downtown Hospitals of the Academic Health Center) were merged and consolidated to form a single corporate entity, which was then licensed as a single acute care

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

1. Organization and Nature of Operations (continued)

hospital and operates as an academic health center. Members of the Board of Directors (the Board) of Indiana University Health are selected by its two classes of members: the Methodist Class (members of which are members of Methodist Health Group, Inc.) and the University Class (members of which are the individuals who are the Trustees of Indiana University).

The Consolidation Agreement requires that the salaries and related employee benefit costs be funded for medical doctor interns and residents of the Indiana University School of Medicine (the School of Medicine). The Board annually reviews and determines the level of support to the School of Medicine for these programs and the number of internships and residencies to be supported. The Consolidation Agreement also provides for additional support to the School of Medicine to recognize, as a result of the consolidation, the enhanced and increased level of services being provided, including services to the medically indigent through medical education and research. Annually (or more often), an appointed committee consisting of representatives of Indiana University Health, Methodist Health Group, Inc., and Indiana University determines the amount of such additional support to be provided to the School of Medicine.

Nature of Operations

The Indiana University Health System operates as an integrated health care delivery system comprising nonprofit and for-profit entities, with coordinated activities and policies designed to meet the mission of the Indiana University Health System. The principal operating activities of the Indiana University Health System are conducted at owned facilities or majority-owned or controlled subsidiaries and consist of the following.

Downtown Hospitals of the Academic Health Center (Hospital Campuses) – Consist of three acute, tertiary, and quaternary care, and diagnostic facilities, licensed as a single hospital, which constitutes the principal hospital activities of the academic health center and whose operations are located in the downtown area of Indianapolis, Indiana. These three hospitals, Methodist Hospital, University Hospital, and Riley Hospital, are located on or near the campus of Indiana University-Purdue University in Indianapolis and the School of Medicine.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

1. Organization and Nature of Operations (continued)

Central Indiana Facilities (Indiana University Health West Hospital (West), Indiana University Health North Hospital (North), Indiana University Health Tipton Hospital (Tipton), Indiana University Health Saxony Hospital (Saxony), and Rehabilitation Hospital of Indiana (RHI)) – Consist of three acute care hospitals, a critical access hospital, and an acute care rehabilitation hospital located in the western and northern suburban areas of metropolitan Indianapolis, Indiana. Saxony operates as a division of the academic health center.

Statewide Facilities – Consist of acute care hospitals and health care systems located in Bedford, Bloomington, Goshen, Hartford City, Knox, Lafayette, LaPorte, Martinsville, Monticello, Muncie, and Paoli, Indiana. Principal hospital subsidiaries include Indiana University Health Bedford Hospital (Bedford), Indiana University Health Arnett Hospital (Arnett), Indiana University Health LaPorte Hospital and subsidiaries (LaPorte) including Indiana University Health Starke (Starke), Indiana University Health Goshen and subsidiaries (Goshen), Indiana University Health Ball Memorial Hospital and subsidiaries (Ball Memorial) including Indiana University Health Blackford (Blackford), Indiana University Health Bloomington Hospital and subsidiaries (Bloomington) including Indiana University Health Paoli (Paoli), Indiana University Health Morgan Hospital (Morgan), and Indiana University Health White Memorial Hospital (White).

Physician Operations – Consist of physician offices and physician-group practices and clinics. Principal subsidiaries or divisions include Indiana University Health Arnett Physicians, Indiana University Health Ball Memorial Physicians, Indiana University Health Southern Indiana Physicians, Indiana University Health LaPorte Physicians, Indiana University Health Goshen Physicians, Indiana University Health Radiology Partners, Inc., and Indiana University Health Transplant Institute. Additionally, physician operations include Indiana University Health Physicians (IUHP), a nonprofit organization with locations primarily in Indianapolis, Indiana.

Ambulatory Care – Consists of personal and home health care services, outpatient oncology services, and outpatient surgery centers, which are located throughout the state of Indiana. Principal subsidiaries or divisions include Indiana University Health Home Care, Central Indiana Cancer Centers, and seven surgery centers.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

1. Organization and Nature of Operations (continued)

Medical Risk – Consists of the medical management of health care services of members whose health care coverage is provided by the managed care networks of the Indiana University Health System.

Foundations – Indiana University Health is the sole corporate member of Methodist Health Foundation, Inc. (Methodist Health Foundation), which aids and supports Methodist Hospital and other programs and areas of Indiana University Health. Ball Memorial is the sole corporate member of Indiana University Ball Memorial Hospital Foundation (BMH Foundation), which aids in carrying out the mission of Ball Memorial. Morgan is the sole corporate member of Indiana University Health Morgan Hospital Foundation (Morgan Foundation), which aids and supports Morgan. Arnett is the sole corporate member of Indiana University Health Arnett Hospital Foundation (Arnett Foundation), which aids and supports Arnett. RHI is the sole corporate member of Rehabilitation Hospital of Indiana Foundation (RHI Foundation), which aids and supports RHI. Goshen is the sole corporate member of Indiana University Health Goshen Foundation (Goshen Foundation), which aids and supports Goshen.

2. Community Benefit and Charity Care

The Indiana University Health System provides health care services and other financial support through various programs that are designed, among other matters, to enhance the health of the community, improve the health of low-income patients, and foster medical education and research through its affiliation with the School of Medicine. In addition, the Indiana University Health System provides services intended to benefit the poor and underserved, including those persons who cannot afford health insurance because of inadequate resources or those who are uninsured or underinsured. Health care services to patients under government programs, such as Medicare and Medicaid, are also considered part of the Indiana University Health System's benefit provided to the community since a substantial portion of such services are reimbursed at amounts less than cost.

The Indiana University Health System's financial assistance policies are designed to provide care to patients regardless of their ability to pay, and all uninsured patients are eligible for discounts from established charges. Patients who meet certain criteria (generally based on up to 400% of federal poverty income guidelines, other patients who are victims of certain catastrophic events,

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

2. Community Benefit and Charity Care (continued)

or those who meet criteria to be part of the Indiana University Health System's medical education and research programs) are provided care without charge or at amounts less than established rates.

Patient service revenue is reported at estimated net realizable amounts for services rendered. The Indiana University Health System recognizes patient service revenue associated with patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, revenue is recognized on the basis of discounted rates in accordance with the uninsured discount policy.

The amount of charity care provided is determined based on the qualifying criteria, as defined in the financial assistance policies, through approved applications completed by patients and their families or beneficiaries, or based on analysis of patients without third-party insurance coverage who did not apply for charity and whose income was equal to or less than 200% of federal poverty income guidelines. No payment for services is anticipated for those patients whose charity care applications have been approved, as well as for those other patient accounts whose income is equal to or less than 200% of federal poverty income guidelines and meet certain other criteria. The cost to provide charity care using the consolidated cost to charge ratio was \$170,937 and \$204,420 for 2013 and 2012, respectively.

In addition, the Indiana University Health System provides a significant amount of uncompensated care to other uninsured and underinsured patients, which is included in the provision for uncollected patient accounts.

Enacted March 23, 2010, the Patient Protection and Affordable Care Act (the Affordable Care Act) required, among other things, that hospital organizations establish a financial assistance policy and a policy relating to emergency medical care. The hospital organizations of the Indiana University Health System have adopted a financial assistance policy that conforms with the Affordable Care Act and includes financial assistance eligibility criteria, the basis for calculating amounts charged to patients, the method for applying for financial assistance, billing and collections policies with regard to actions that may be taken in the case of nonpayment, as well as measures to widely publicize the policy within the communities served. Additionally, the Indiana University Health System's hospital organizations have adopted policies requiring the organizations to provide, without discrimination, care for emergency medical conditions to individuals regardless of their eligibility under their financial assistance policy. These hospital

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

2. Community Benefit and Charity Care (continued)

organizations have also adopted policies to limit the amount charged for emergency or other medically necessary care that is provided to individuals eligible for assistance under the organizations' financial assistance policy to not more than the amounts generally billed to individuals who have insurance covering such care.

Reimbursements are received by the Indiana University Health System for Medicare and Medicaid beneficiaries in accordance with reimbursement agreements and related regulatory rules and regulations. Also, the Indiana University Health System receives certain additional Medicaid Disproportionate Share (DSH) payments and payments under the Medicaid Assessment Fee program from the state of Indiana (see Note 3). These reimbursements and payments are less than the cost of providing the related services.

The Indiana University Health System also provides education for health care providers, including support to the School of Medicine; counseling centers and chaplaincy programs that support patients' medical, spiritual, and emotional needs; programs to enhance quality of and respect for life, including neighborhood revitalization, community health clinics, and school-based health programs; charity, equality, and justice programs, including education programs available to independent health providers, and obesity prevention programs such as Garden on the Go and Indy Urban Acres, other medical research, and support to the Children's Values Fund; and fosters an internal community of trust, respect, and empowerment.

Through the statewide facility-by-facility community health needs assessments Indiana University Health conducted, the following community health needs were identified and selected as priority areas in which Indiana University Health will focus on community benefit efforts: access to affordable health care, behavioral health, obesity prevention, and Pre-K education. The costs of providing these programs and services are included in expenses in the accompanying consolidated statements of operations and changes in net assets.

3. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Indiana University Health and all majority-owned or controlled subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Fair Values of Financial Instruments

Financial instruments include cash and cash equivalents, patient, other accounts receivable, assets limited as to use, accounts payable and accrued expenses, estimated third-party payor allowances, notes payable to banks, long-term debt, derivative financial instruments (i.e., fixed payor and basis swaps), and certain other current assets and liabilities.

The fair values for cash and cash equivalents, patient, other accounts receivable, accounts payable and accrued expenses, estimated third-party payor allowances, and certain other current assets and liabilities approximate the carrying amounts reported in the consolidated balance sheets and, in the opinion of management, represent highly liquid assets or short-term obligations. The fair values for assets limited as to use, long-term debt, and derivative financial instruments are described in Notes 5, 7, 8, and 9.

Derivative Financial Instruments

The Indiana University Health System has entered into certain interest rate swap transactions (fixed-pay swaps and basis swaps). As of and for the years ended December 31, 2013 and 2012, the Indiana University Health System's fixed-pay swap and basis swap agreements did not qualify for hedge accounting. Therefore, the changes in fair value of these interest rate swaps during these years are reported with nonoperating income in the consolidated statements of operations and changes in net assets.

Patient Service Revenue

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payors, and others at the time services are rendered. Certain revenue is subject to estimated retroactive revenue adjustments under reimbursement agreements with third-party payors due to

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period that the related services are rendered, and such amounts are adjusted in future periods as adjustments become known.

For the year ended December 31, 2013, the percentage of patient service revenue (net of contractually and discounts) derived under Medicare, Medicaid, and managed care programs approximated 24%, 6%, and 58%, respectively (23%, 7%, and 55%, respectively, in 2012). A managed care provider represented 29% and 26% of net patient service revenue in 2013 and 2012, respectively. Provision has been made, by a charge to contractual allowances as an offset to patient service revenue, for the differences between gross charges for patient services and estimated reimbursement from these government and insurance programs.

Indiana University Health is a Medicaid DSH provider under Indiana law (IC 12-15-16(1-3)) and, as such, is eligible to receive state DSH payments. The amount of these additional state DSH funds is dependent on regulatory approval by agencies of the federal and state governments and is determined by the level, extent, and cost of uncompensated care (as defined) and various other factors. For the years ended December 31, 2013 and 2012, state DSH payments have been made by the state of Indiana, and amounts were recorded as revenue based on data acceptable to the state of Indiana, less any amounts management believes may be subject to adjustment. State DSH payments by the state of Indiana are based on the fiscal year of the state, which ends June 30 of each year. State DSH reimbursement is recognized as revenue after eligibility is determined by the state and payments are probable and reasonably estimable. The 2012 through 2013 state DSH payments of \$63,261 recognized by Indiana University Health and certain subsidiaries during 2013 were recorded in net patient service revenue in the accompanying consolidated statements of operations and changes in net assets for the year ended December 31, 2013. The 2010 through 2012 state DSH payments of \$110,334 recognized by Indiana University Health and certain subsidiaries during 2012 were recorded in net patient service revenue in the accompanying consolidated statements of operations and changes in net assets for the year ended December 31, 2012.

During 2012, the Indiana General Assembly approved a hospital assessment fee program (Medicaid Assessment Fee). Under this program, the Office of Medicaid Policy and Planning (OMPP) collects a fee from eligible hospitals. The fee is used in part to increase reimbursement to eligible hospitals for services provided in both fee-for-service and managed care programs,

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

and as the state share of DSH payments. The program was effective retroactively from July 1, 2011 and continued through June 30, 2013. During the year ended December 31, 2013, increased reimbursement related to the Medicaid Assessment Fee program totaled \$176,184, of which \$9,622 related to 2012. During the year ended December 31, 2012, increased reimbursement related to the Medicaid Assessment Fee program totaled \$474,235, of which \$161,802 related to 2011. During the year ended December 31, 2013, an assessment fee was recognized of \$82,442, of which \$11,574 related to 2012. During the year ended December 31, 2012, an assessment fee was recognized of \$179,834, of which \$59,936 related to 2011. This fee was recorded within the hospital assessment fee on the consolidated statements of operations and changes in net assets.

The Indiana General Assembly approved the extension of the Medicaid Assessment Fee program for another four years. As of December 31, 2013, this extension was awaiting approval from the Centers for Medicare and Medicaid Services. Because the approval had not been obtained as of December 31, 2013, no Medicaid Assessment Fee program revenue or assessment fee expense has been recorded for Medicaid claims with a service date of July 1, 2013 and after. Subsequently, on March 21, 2014, the Centers for Medicare and Medicaid Services approved the extension of the program for another four years. This approval reinstated the program retroactively to July 1, 2013. The Indiana University Health System will record the increased revenue and assessment fee expense related to claims occurring after July 1, 2013 in the first quarter of 2014, and such increased revenue is expected to be material, as it was during the first six months of 2013.

Laws and regulations governing Medicare, Medicaid, and other governmental programs are extremely complex, subject to interpretation, and sometimes provide for retroactive adjustments. As a result, there is a reasonable possibility that recorded estimated settlements could change by a material amount in the near term. The Indiana University Health System believes it is in compliance with applicable laws and regulations governing Medicare, Medicaid, and other governmental programs and that adequate provisions have been recorded for any adjustments that may result from final settlements. However, any adjustments to the currently estimated settlements are recorded in future periods.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

During 2012, the Indiana University Health System received a settlement from the United States Department of Health & Human Services and Centers for Medicare & Medicaid Services related to underpayments for Medicare services dating back several years in the amount of \$22,570. The settlement was recorded within net patient service revenue in the accompanying consolidated statements of operations and changes in net assets.

Patient service revenue, net of contractual allowances and discounts and before the provision for bad debts, recognized in the year from major payor sources is as follows:

	Year Ended December 31	
	2013	2012
Third-party payors	\$ 5,041,753	\$ 5,294,741
Self-pay patients	186,285	154,664
Total payors	<u>\$ 5,228,038</u>	<u>\$ 5,449,405</u>

Member Premium Revenue and Health Claims

The Indiana University Health System has agreements to provide medical services to subscribing participants or members that generally provide for predefined payments (on a per member or per month basis) regardless of services actually performed. The cost to provide health care services under these agreements, and for self-insured health benefits to employees, is accrued in the period in which the health care services are provided to a member or covered employee based, in part, on estimates, including an accrual for medical services provided but not yet reported. Expenses to providers are reported as health claims to providers in the accompanying consolidated statements of operations and changes in net assets. The accrual for medical services provided but not yet reported is reflected as accrued health claims in the accompanying consolidated balance sheets.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

Meaningful Use Revenue

The American Recovery and Reinvestment Act of 2009 established incentive payments under Medicare and Medicaid programs for certain eligible professionals, hospitals, and critical access hospitals (Providers). Providers can receive incentive payments by adopting, implementing, and upgrading electronic health records (EHR) technology. Providers can also receive incentive payments for demonstrating meaningful use of EHR technology. Upon satisfaction of the meaningful use criteria, using a grant accounting model, the Indiana University Health System recognized \$22,215 and \$24,133 of these incentive payments within other revenue in the accompanying consolidated statements of operations and changes in net assets for the years ended December 31, 2013 and 2012, respectively. If specified meaningful use criteria are met in future periods, the Indiana University Health System may qualify for additional incentive payments.

Cash Equivalents

Investments in highly liquid instruments with an original maturity of three months or less when purchased, excluding assets limited as to use, are considered by management to be cash equivalents.

The Indiana University Health System routinely invests in money market funds, including both treasury and agency money market funds and prime money market funds that are considered by management to be cash equivalents. Such instruments, as well as bank deposits, are potentially subject to concentrations of credit risk. In order to mitigate such risk, the Indiana University Health System generally places its cash and cash equivalents with institutions of high credit quality and/or positions them such that they are insured by the Federal Deposit Insurance Corporation.

Accounts Receivable and Allowance for Uncollectible Accounts

The Indiana University Health System does not require collateral or other security for the delivery of health care services from its patients, substantially all of whom are residents of the state of Indiana. However, assignment of benefit payments payable under patients' health insurance programs and plans (e.g., Medicare, Medicaid, health maintenance organizations, and commercial insurance policies) is routinely obtained, consistent with industry practice.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

The provision for uncollected patient accounts, for all payors, is recognized when services are provided based upon management's assessment of historical and expected net collections, taking into consideration business and economic conditions, changes and trends in health care coverage, and other collection indicators. Periodically, management assesses the adequacy of the allowance for uncollectible accounts based upon accounts receivable payor composition and aging, the significance of individual payors to outstanding accounts receivable balances, and historical write-off experience by payor category, as adjusted for collection indicators. The results of this review are then used to make any modifications to the provision for uncollected patient accounts and the allowance for uncollectible accounts. In addition, the Indiana University Health System follows established guidelines for placing certain past due patient balances with collection agencies. Patient accounts that are uncollected, including those placed with collection agencies, are initially charged against the allowance for uncollectible accounts in accordance with collection policies of the Indiana University Health System and, in certain cases, are reclassified to charity care if deemed to otherwise meet financial assistance policies of the Indiana University Health System.

The composition of net patient accounts receivable is summarized as follows as of December 31:

	2013	2012
Managed care	54%	51%
Medicare	21	21
Medicaid	5	7
Other third-party payors	11	12
Patients	9	9
	100%	100%

A managed care payor represented 23% and 24% of net patient accounts receivables at December 31, 2013 and 2012, respectively.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

The allowance for uncollectible accounts for self-pay patients, including self-pay discounts and charity care, was 86% of self-pay accounts receivable as of December 31, 2013 and 2012. Overall, the net of self-pay discounts and write-offs has not changed significantly for the years ended December 31, 2013 and 2012. The Indiana University Health System has not experienced significant changes in write-off trends and has not changed its financial assistance policy during the year ended December 31, 2013.

Inventories

Inventories consist primarily of drugs and supplies, are stated at the lower of cost or market, and are generally valued using the average cost method.

Assets Limited as to Use

Assets limited as to use include the following: (i) cash and cash equivalents and designated investment assets, including those funds held by the consolidated foundations, set aside by the Board for future capital improvements and for other purposes, over which the Board retains control and may, in certain circumstances, use for other purposes; (ii) donor-restricted investment assets, the use of which has been specified by the donor; (iii) assets held by trustees under bond or trust indenture agreements for construction and debt service; and (iv) cash and equivalents and designated investment assets set aside for near-term capital improvements and other purposes, over which management retains control and may use for other purposes and which are classified as other investments. Substantially all assets limited as to use are invested and managed by professional investment managers and are held in custody by financial institutions. These funds are classified as trading securities. Accordingly, changes in unrealized gains and losses in the fair value of investments are included in nonoperating income within investment income in the accompanying consolidated statements of operations and changes in net assets. The Indiana University Health System is a limited partner in certain funds that employ hedged investment strategies. These investments are accounted for using the equity method of accounting, based on the fund's financial information.

Property and Equipment

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the assets. Included in property and equipment are costs for software developed for internal use.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

Property and equipment under capital lease obligations are amortized on the straight-line method over the lease term or the estimated useful life of the equipment, whichever period is shorter. Such amortization is included with depreciation in the accompanying consolidated statements of operations and changes in net assets. Interest cost incurred on borrowed funds during the period of construction and other interest costs related to tax-exempt bonds are capitalized as a component of the cost of constructing the assets. In addition, interest earnings on unexpended borrowed funds related to tax-exempt financings offset capitalized tax-exempt interest. Repair and maintenance costs are expensed when incurred.

The Indiana University Health System evaluates when events or changes in circumstances have occurred that would indicate that the remaining estimated useful life of long-lived assets warrant revision or that the remaining balance of such assets may not be recoverable. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or asset group. If undiscounted cash flows are insufficient to recover the carrying value of the long-lived asset, such asset is written down to its fair value if its carrying value exceeds fair value.

Equity Interest in Unconsolidated Subsidiaries

Indiana University Health or its subsidiaries have also entered into certain limited liability company agreements with third parties that provide health care-related services. Where applicable, these arrangements are accounted for using the equity method of accounting. Indiana University Health's largest equity interest venture is a 50% membership interest in MDWise, Inc., which holds an HMO license and manages a network of health care providers serving Indiana Medicaid patients throughout the state of Indiana. The balance of this equity interest was \$17,574 and \$18,181 as of December 31, 2013 and 2012, respectively. Overall, equity interest in unconsolidated subsidiaries was \$44,578 and \$57,819 as of December 31, 2013 and 2012, respectively. The Indiana University Health System has recorded its equity in the income of its unconsolidated subsidiaries within other operating revenue, totaling \$1,145 and \$3,603 for the years ended December 31, 2013 and 2012, respectively.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

During 2013, Indiana University Health determined that the value of its investments in certain equity method investments was other-than-temporarily impaired and the investments were reduced to their estimated fair value, which is nominal, through the recording of \$3,028 and \$7,106 impairment changes included in other operating revenue and nonoperating income, respectively, in the accompanying consolidated statements of operations and changes in net assets.

Unamortized Bond Issuance Costs and Bond Discount or Premium

Costs incurred in connection with the issuance of long-term debt and bond discounts or premiums are amortized or accreted using the effective interest rate method. Amortization and accretion are included in interest expense in the accompanying consolidated statements of operations and changes in net assets (see Note 7).

Contributions

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Conditional promises to give, including indications of an intention to give, are reported at fair value at the date the gift is received. If the gifts are received with donor stipulations that limit the use of the donated assets, the gifts are reported as either temporarily or permanently restricted. Donor-restricted contributions for which restrictions are met in the same year as received are reported as unrestricted contributions in the accompanying consolidated financial statements.

Noncontrolling Interest in Subsidiaries

The Indiana University Health System attributed income of \$92,846 and \$67,377 for the years ended December 31, 2013 and 2012, respectively, to the noncontrolling interests based on the ownership percentage of the noncontrolling interests in certain of the Indiana University Health System's consolidated subsidiaries. These amounts are reflected in unrestricted net assets in the consolidated balance sheets.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets are those assets whose use has been limited by donors to a specific time period or purpose. These net assets are generally restricted for medical education and research programs, medical supplies and equipment, and patient care services.

Interests in net assets of unconsolidated foundations are included in other assets in the accompanying consolidated balance sheets. The underlying assets of these interests in foundations consist primarily of cash and cash equivalents, money market and mutual funds, and marketable equity and debt securities (see Note 14).

Business Combinations

The Indiana University Health System allocates the purchase price of an acquisition to the various components of the acquisition based upon the fair value of each component, which may be derived from various observable or unobservable inputs and assumptions. Also, the Indiana University Health System may utilize third-party valuation specialists. These components typically include buildings, land, and equipment and may also include intangibles related to noncompete agreements or other specifically identified intangible assets. The excess of the fair value of assets acquired over liabilities assumed and the fair value of any noncontrolling interest is recorded as an inherent contribution within the performance indicator. Goodwill is recorded to the extent that liabilities assumed and noncontrolling interests exceed the fair value of assets acquired.

Goodwill and Intangible Assets

In connection with business combinations, the Indiana University Health System has recorded goodwill and definite-lived intangible assets on the accompanying consolidated balance sheets.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

The Indiana University Health System evaluates goodwill for impairment annually, or more frequently if events or changes in circumstances suggest that the carrying value of an asset may not be recoverable. The goodwill impairment analysis, performed at the reporting unit level, generally includes estimating the fair value and comparing that to the carrying value. If fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to be impaired. These valuation methods require the Indiana University Health System to make estimates and assumptions regarding future operating results, cash flows, changes in working capital, capital expenditures, profitability, and the cost of capital.

The Indiana University Health System also reviews if events or changes in circumstances suggest impairment may have occurred related to the carrying value of the definite-lived intangible assets, which are amortized over periods of 5 to 35 years. It has been determined that there was no impairment to goodwill or definite-lived intangible assets during 2013 and 2012. Intangible assets included in other assets on the accompanying consolidated balance sheets as of December 31, 2013 and 2012, were \$182,339 and \$184,145, respectively, which include goodwill of \$166,559 and \$166,801, respectively.

Operating and Performance Indicators

The activities of the Indiana University Health System are primarily related to providing health care services, and accordingly, expense information by functional classification is not used as a basis for measuring performance. Furthermore, since substantially all resources are derived from providing health care services, similar to that if provided by a business enterprise, the following indicators are considered important in evaluating how well management has discharged its stewardship responsibilities:

Operating Indicator (Operating Income) – Includes all unrestricted revenue, gains, donor contributions to offset operating expenses, other support, equity income or loss of unconsolidated health care subsidiaries, and expenses directly related to the recurring and ongoing health care operations during the reporting period. The operating indicator excludes investment income or losses on assets limited as to use (including changes in unrealized gains and losses on investments), changes in the fair value of fixed-pay and basis swaps, gain or loss on the extinguishment of debt, inherent contribution of acquired entities, noncontrolling interest, and gains and losses deemed by management not to be directly related to providing health care services.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

3. Summary of Significant Accounting Policies (continued)

Performance Indicator (Excess of Revenues Over Expenses) – Includes operating income and nonoperating income (losses). The performance indicator excludes certain changes in pension obligations and contributions for capital expenditures, distributions, and net assets released from restricted funds.

Income Taxes

The Internal Revenue Service (IRS) has determined that Indiana University Health and certain of its affiliated entities are tax-exempt organizations as defined in Section 501(c)(3) of the Internal Revenue Code.

Certain subsidiaries of Indiana University Health are taxable entities. The tax expense and liabilities of these subsidiaries are not material to the consolidated financial statements.

Subsequent Events

For the consolidated financial statements as of and for the year ended December 31, 2013, management has evaluated subsequent events through March 27, 2014, the date that these consolidated financial statements were issued.

4. Significant Transactions

On October 1, 2013, Indiana University Health System announced a workforce reduction, including an early retirement program. As of December 31, 2013, Indiana University Health System had paid \$6,295 in severance costs related to this reduction. As of December 31, 2013, \$9,065 estimated self-insured unemployment costs, unpaid severance costs, and estimated benefit costs related to the retirees were accrued within accrued salaries, wages, and related liabilities.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

4. Significant Transactions (continued)

Indiana University Health Occupational Services

Effective July 1, 2013, Indiana University Health Occupational Services, a wholly owned subsidiary of Indiana University Health, sold the operations and related fixed assets of eight freestanding clinics located in Fishers, Indianapolis, Lebanon, and Muncie, Indiana, to U.S. Healthworks of Indiana, Inc. for a purchase price of \$14,500, of which \$13,050 was received in July. The remaining amount to be received is recorded within other receivables and is expected to be collected by December 2014. The gain related to this sale was \$12,734 and is recorded within other nonoperating income. Prior to this sale, on June 27, 2013, Indiana University Health, acting as Obligated Agent for Indiana University Health Obligated Group, effectuated the removal of Indiana University Health Occupational Services as an Obligated Group Affiliate under the Master Trust Indenture (as such terms are defined in the Master Trust Indenture). See Note 7 for further discussion on Indiana University Health Obligated Group.

Rehabilitation Hospital of Indiana

Effective April 9, 2012, the bylaws of RHI were amended to provide Indiana University Health with a 51% voting interest in participatory matters, so that Indiana University Health became the controlling member in RHI. Purchase accounting was applied to this transaction as Indiana University Health obtained control of the entity, which was previously accounted for under the equity method. As such, the assets, liabilities, and noncontrolling interests of RHI were recorded at fair value. Indiana University Health recorded the value of working capital and assets limited to use of \$14,613, property and equipment and other assets of \$13,713, and ownership interests of \$7,593. Long-term debt and other liabilities of \$20,733 were assumed.

Indiana University Health remeasured its previous equity method investment upon the change in control, which resulted in a gain of \$2,200 recorded within other nonoperating income in the accompanying consolidated statements of operations and changes in net assets, representing the fair value of Indiana University Health's equity interest in RHI in excess of its previous carrying value. The financial position of RHI was consolidated with Indiana University Health effective with the amendment, and the financial results of RHI were consolidated beginning on that date. The purchase price allocation was finalized during 2013 and there were no material changes from the preliminary allocations recorded in 2012.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

5. Assets Limited as to Use

Board-designated and donor-restricted investment funds are invested in accordance with Board-approved policies. Trustee-held funds are generally invested in cash equivalents (including money market funds) and U.S. government and agency obligations, as defined by the debt agreements.

The estimated fair value of the assets limited as to use is determined using market information and other appropriate valuation methodologies. The methods and assumptions used to estimate the fair value of assets limited as to use are as follows: (i) cash and cash equivalents: the carrying amounts reported in the consolidated balance sheets approximate fair value; (ii) marketable securities: the fair values are based on quoted market prices or, if quoted market prices are not available, quoted market prices of comparable instruments and other observable inputs; and (iii) other investments, including alternative investments (such as hedge funds and private equity investments): accounted for using the equity method of accounting based upon the net asset values as determined by third-party administrators of each fund in consultation with and approval of the fund investment managers.

The Indiana University Health System is a limited partner in funds that employ hedged investment strategies and funds that employ investment strategies that require long holding periods to create value, both of which are designed to reduce overall portfolio volatility. In the case of hedged strategies, redemptions generally may be made quarterly with written notice ranging from 30 to 90 days; however, some funds employ lock-up periods that restrict redemptions or charge a redemption fee during the lock-up period. Lock-up periods range from one to three years with redemption charges of up to 5% of net asset value for redemptions made on or before the anniversary date of the initial investment or additional contribution. Upon complete redemption, many of the funds have “hold-back” provisions that allow the fund to retain up to 10% of the assets until the fund completes its audited financial statements for the

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

5. Assets Limited as to Use (continued)

redemption period. These investments are accounted for using the equity method of accounting, based on the fund's financial information. In the case of long holding period strategies, capital is returned as monetization events occur which may be infrequent in nature. Generally, capital is committed to a partnership for a period of five to ten years with the ability of the general partner to extend the life of the fund one to three additional years. During the first three to five years of a fund life, the general partner, in order to facilitate its funding of investments, will call capital from the limited partners up to the amount of its commitment. As of December 31, 2013, there was \$25,259 of unfunded commitments relating to alternative investments, which is expected to be paid over the next four years. There were no material unfunded commitments as of December 31, 2012.

Alternative investments include certain other risks that may not exist with other investments that are more widely traded. These include reliance on the skill of the fund managers, who often employ complex strategies utilizing various financial instruments, including futures contracts, foreign currency contracts, structured notes, and interest rate, total return, and credit default swaps. Additionally, alternative investments may provide limited information on a fund's underlying assets and have restrictive liquidity provisions. Management believes that the Indiana University Health System, in consultation with its investment consultants, has the capacity to analyze and interpret the risks associated with alternative investments and, with this understanding, has determined that these investments represent a prudent approach for use in its portfolio management.

The largest fund allocation to any fund manager, which is an alternative fund of funds investment, is \$161,109 at December 31, 2013, and there are no investments in any individual fund greater than 15.5% of that fund's net assets. Changes in the value of these funds are included in nonoperating income and losses in the accompanying consolidated statements of operations and changes in net assets.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

5. Assets Limited as to Use (continued)

The composition of assets limited as to use is set forth below.

	December 31	
	2013	2012
Board-designated investments and trustee-held funds:		
Cash and cash equivalents	\$ 62,424	\$ 58,634
Marketable securities:		
U.S. government and agency obligations	138,649	111,826
U.S. corporate obligations	340,379	354,825
U.S. equity securities	438,318	351,908
Non-U.S. securities	451,671	272,789
Total marketable securities	1,369,017	1,091,348
Other Board-designated investments:		
Alternative investments:		
Hedged strategy (fund of funds)	439,343	423,480
Hedged strategy (direct)	275,979	118,168
Long holding period strategy	44,641	—
Real estate investment trusts and other	8,486	7,799
Total other Board-designated investments	768,449	549,447
Total Board-designated investments and trustee-held funds	2,199,890	1,699,429
Other investments:		
Cash and cash equivalents	2,071	8,539
U.S. government and agency obligations	163,894	184,216
U.S. corporate obligations	219,698	162,252
Non-U.S. securities	43,691	22,117
Total other investments	429,354	377,124
Total assets limited to use	2,629,244	2,076,553
Less current portion	(114)	(501)
Total assets limited to use, less current portion	\$ 2,629,130	\$ 2,076,052

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

5. Assets Limited as to Use (continued)

Assets limited as to use include funds held by the foundations whose fair values as of December 31, 2013, aggregated \$200,610, of which \$106,554 is considered Board-designated investment funds and \$94,057 is considered donor-restricted investment funds.

The composition and presentation of investment income recognized in the accompanying consolidated statements of operations and changes in net assets are as follows:

	Year Ended December 31	
	2013	2012
Investment income:		
Interest and dividend income	\$ 35,352	\$ 31,649
Investment management and administration fees	(6,101)	(3,063)
Realized gains on sales of investments, net	89,002	35,086
Unrealized gains on investments	63,199	62,358
Equity gains of hedged strategy funds	9,631	21,872
	<u>\$ 191,083</u>	<u>\$ 147,902</u>

6. Property and Equipment

The cost of property and equipment in service is summarized as follows:

	December 31	
	2013	2012
Land and improvements	\$ 264,622	\$ 260,329
Buildings and improvements	3,234,771	3,241,646
Equipment (including software developed for internal use of \$234,604 in 2013 and \$221,309 in 2012)	2,191,292	2,071,795
	<u>\$ 5,690,685</u>	<u>\$ 5,573,770</u>

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

6. Property and Equipment (continued)

Useful lives of each category of assets are based on the estimated useful time frame that the particular assets are expected to be in service, generally in accordance with guidelines established by the American Hospital Association. Assets are depreciated on a straight-line basis beginning in the month when placed in service, with asset lives ranging as follows: 20-30 years for land improvements, 15-40 years for buildings and improvements, and 3-10 years for equipment, including software developed for internal use.

Construction-in-progress for assets currently under development is anticipated to extend through 2014 and includes commitments for the construction, refurbishment, and replacement of facilities and equipment. A summary of the construction-in-progress is as follows:

	December 31	
	2013	2012
Software developed for internal use	\$ 79	\$ 13,772
Riley Simon Family Tower	70,941	13,294
Other facilities and equipment	44,033	17,401
	<u>\$ 115,053</u>	<u>\$ 44,467</u>

Firm commitments for construction-in-progress totaled \$36,737 at December 31, 2013.

Certain buildings, medical and computer equipment, and software are accounted for as capital leases expiring in various years through 2021 and are included in property and equipment. Amortization of assets under capital leases is included in depreciation expense.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

6. Property and Equipment (continued)

The following is a summary of property held under capital leases:

	December 31	
	2013	2012
Software	\$ 1,985	\$ 1,985
Computer and office equipment	13,686	11,485
Medical equipment	23,565	28,542
Buildings	112,877	119,258
	152,113	161,270
Less accumulated amortization	(33,172)	(26,940)
	\$ 118,941	\$ 134,330

Interest rates are imputed based on the lower of the incremental borrowing rate at the inception of each lease or the lessor's implicit rate of return.

7. Debt

Obligated Groups

The Indiana University Health System operates under three separate Master Trust Indentures (MTIs). Each indenture provides for the issuance of long-term debt under various obligated group structures. The obligated groups and their respective members consist of the specific separate entities so named in the indenture and are described as follows: (1) the Indiana University Health Obligated Group, which includes the Downtown Hospitals of the Academic Health Center, LaPorte, and Saxony (a division of Indiana University Health) as members; (2) the Ball Memorial Obligated Group, including Ball Memorial and Blackford as members; and (3) the Rehabilitation Hospital of Indiana Obligated Group, which includes RHI as the sole member. A fourth obligated group, the Bloomington Obligated Group, existed as of December 31, 2012, but made full payment and satisfaction of all its obligations during 2013. Each obligated group is required to meet certain covenants, and its members are jointly and severally liable for the obligations under their respective MTIs. Each is subject to financial performance covenants that, among other compliance requirements, require the maintenance of

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

7. Debt (continued)

debt service ratios and limit its ability to encumber certain of its respective assets. As of December 31, 2013, the Indiana University Health System was in compliance with all financial covenants.

Issuance and Extinguishment of Debt

Indiana University Health Obligated Group

On June 29, 2012, a direct bank loan (which was used to redeem Series 2003F bonds) was amended to defer the maturity date to June 30, 2014, with an interest rate based on one-month London Interbank Offered Rate (LIBOR). This agreement requires nominal principal payments during the term with all remaining principal due at maturity. As of December 31, 2013, the amount outstanding for this loan was \$40,000, which amount is classified under current portion of long-term debt on the December 31, 2013 consolidated balance sheet.

The Indiana University Health Obligated Group has executed direct-pay letter-of-credit agreements in support of all of its publicly remarketed variable-rate bond series, which require the credit provider to purchase bonds in the event the bonds are not remarketed. In addition, it has executed direct purchase agreements, whereby the credit provider purchases bonds for a predetermined period of time, after which the agreement must be extended or the bonds must be remarketed or reissued. In each of these two instances, the bonds have a longer nominal maturity than the agreement, but the existence and terms of these agreements allow for the long-term classification of the associated variable-rate bond series. None of these agreements expire during 2014.

Ball Memorial Obligated Group

On April 1, 2013, the Ball Memorial Obligated Group redeemed at par (\$5,495) all of the outstanding Hospital Authority of Delaware County Hospital Revenue Refunding Bonds, Series 1997. These bonds carried a fixed interest rate of 5.00%.

Other Debt

The Stonehenge Community Development VII, LLC, Fixed Rate, Unsecured New Market Tax Credit Notes A and B were called by the lender for a one-time payment of \$18,700 during the

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

7. Debt (continued)

180 day period beginning February 15, 2014. Accordingly, \$18,700 of the \$25,000 obligation is classified under current portion of long-term debt on the December 31, 2013, consolidated balance sheet. The remaining \$6,300 is classified as long-term.

Long-term debt as of December 31, 2013 and 2012, consists of the following:

	2013	2012
Indiana University Health Obligated Group		
Indiana Finance Authority:		
Fixed Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2011N Serial and Term Bonds, payable in varying principal installments through 2038, with interest rates ranging from 3.00% to 5.13% at December 31, 2013	\$ 184,215	\$ 197,960
Variable-Rate Demand Notes, Tax-Exempt Revenue Refunding Bonds, Series 2011A, B, C, D, E, H, I, L, and M, payable in varying installments through 2036, with variable interest rates ranging between 0.03% and 0.84% at December 31, 2013	449,820	457,320
Variable-Rate Demand Notes, Taxable Hospital Revenue Bonds, Series 2011J and K, payable in varying principal installments through 2033, with an interest rate of 0.08% at December 31, 2013	159,605	163,245
Indiana Health and Educational Facility Financing Authority:		
Fixed Rate, Tax-Exempt Hospital Revenue Bonds, Series 2006A and 2006B Serial and Term Bonds, payable in varying principal installments through 2040, with interest rates ranging from 4.75% to 5.25% at December 31, 2013	666,500	672,285
Variable-Rate Commercial Bank Loan, expiring in 2014 with nominal principal installments through 2038, with an interest rate of 0.67% at December 31, 2013	40,000	40,900
Fixed Rate Commercial Bank Loan, payable in varying principal installments through 2016, with an interest rate of 4.75% at December 31, 2013	17,439	26,526

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

7. Debt (continued)

	2013	2012
Ball Memorial Obligated Group		
Hospital Authority of Delaware County, Indiana:		
Fixed Rate, Tax-Exempt Revenue Refunding Bonds, Series 2009A, 2006, and 1997 Serial and Term Bonds, payable in varying principal installments through 2040, with interest rates ranging from 5.00% to 5.63% at December 31, 2013	\$ 83,800	\$ 91,840
Bloomington Obligated Group		
Hospital Authority of Monroe County, Indiana:		
Variable-Rate, Tax-Exempt Equipment Financing Agreements, repaid in 2013	—	5,526
Rehabilitation Hospital of Indiana Obligated Group		
Indiana Finance Authority:		
Variable-Rate Demand Notes, Tax-Exempt Hospital Revenue Bonds, Series 2011A, payable in varying principal installments through 2031, with an interest rate of 0.05% at December 31, 2013	15,550	16,070
Variable-Rate, Subordinated Promissory Note, principal payable in full at maturity in 2017, with an interest rate of 0.01% at December 31, 2013	1,500	1,500
Other Debt		
Bloomington, Variable-Rate, Taxable Revenue Bonds, Series 2008 Private Placement Bonds, payable in quarterly installments through 2019, variable interest rate of 0.72% at December 31, 2013	2,299	2,736
Stonehenge Community Development VII, LLC, Fixed Rate, Unsecured New Market Tax Credit Notes A and B, due in 2014 at an interest rate of 3.29%	25,000	25,000
Mortgage obligations (interest rates ranging from 1.42% to 6.00%)	6,101	9,497
Capital lease obligations	108,484	125,861
Other	24,024	33,789
Total long-term debt	1,784,337	1,870,055
Unamortized premium, net of unamortized discount	14,461	15,629
Less current portion	(116,149)	(60,853)
Long-term debt, less current portion	\$ 1,682,649	\$ 1,824,831

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

7. Debt (continued)

The scheduled maturities and mandatory redemptions of long-term debt, assuming remarketing of variable-rate bonds, are as follows:

	Indiana University Health Obligated Group	Ball Memorial Obligated Group	RHI Obligated Group	Other	Total
Year ending December 31:					
2014	\$ 81,168	\$ 2,675	\$ 570	\$ 31,736	\$ 116,149
2015	41,101	2,810	615	9,203	53,729
2016	40,010	2,950	650	7,447	51,057
2017	41,800	3,110	2,195	4,952	52,057
2018	43,595	5,160	740	4,984	54,479
Thereafter	1,269,905	67,095	12,280	107,586	1,456,866
	<u>\$ 1,517,579</u>	<u>\$ 83,800</u>	<u>\$ 17,050</u>	<u>\$ 165,908</u>	<u>\$ 1,784,337</u>

The estimated valuation of the revenue bonds is obtained from a third-party pricing service and is derived by utilizing well-priced, liquid bonds with similar characteristics such as currency, market type, industry, and credit rating. Pricing data for these reference bonds incorporates simple averages of indicative and executable price quotes obtained from various contributors, including brokers and other market makers, over a specified time window. These prices are used to construct a fair value curve, which in turn is used to discount the future cash flows of the revenue bonds. Based on the inputs used in determining the estimated fair value of these securities, this liability would be classified as Level 2 in the fair value hierarchy described in Note 9.

The estimated fair value of the revenue bonds at December 31, 2013 and 2012, amounted to \$1,581,630 (which includes Ball Memorial – \$86,591 and RHI – \$15,550) and \$1,669,299 (which includes Ball Memorial – \$98,736 and RHI – \$16,070), respectively. The carrying value of the revenue bonds at December 31, 2013 and 2012, amounted to \$1,559,490 and \$1,598,720, respectively. The recorded value of all debt obligations not traded in the secondary credit markets approximated fair value at December 31, 2013 and 2012.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

7. Debt (continued)

During 2012, Indiana University Health renewed its \$86,000 secured line of credit, which is secured under the terms of its Obligated Group MTI, bears interest on a variable rate based on LIBOR, and matures June 30, 2015. As of December 31, 2013 and 2012, the Indiana University Health System maintained several lines of credit totaling \$91,000. There was no balance drawn on the lines of credit as of December 31, 2013 or December 31, 2012.

Total interest paid on long-term debt for the years ended December 31, 2013 and 2012, aggregated \$81,882 and \$81,342, respectively. Total interest capitalized during the years ended December 31, 2013 and 2012, amounted to \$4,773 and \$3,862, respectively.

8. Derivative Financial Instruments

Long-term interest rate swap arrangements have been entered into with the primary objective being to mitigate interest rate risk. The following fixed-pay swaps, stated at current notional amounts, remain in place as of December 31, 2013:

Notional Amount	Effective Date	Maturity Date	Rate Received	Rate Paid
\$ 52,000	11/15/2005	2/16/2021	62.30% LIBOR plus 0.24%	3.19%
60,195	6/23/2011	3/01/2036	62.30% LIBOR plus 0.24%	2.68
70,425	11/15/2005	2/15/2030	62.30% LIBOR plus 0.24%	3.35
70,725	6/20/2011	2/15/2030	62.30% LIBOR plus 0.24%	3.35
59,675	6/26/2003	3/01/2033	LIBOR	4.92
99,438	6/16/2011	3/01/2033	LIBOR	4.92
39,775	6/26/2003	3/01/2033	LIBOR	4.92
			Securities Industry and Financial Markets Association Municipal Swap Index (SIFMA)	
9,900	1/27/2006	11/02/2020		3.98
1,968	6/01/2004	6/01/2024	LIBOR plus 1.50%	7.05
1,406	6/01/2006	6/01/2026	LIBOR plus 1.25%	7.15
161	10/01/1999	10/01/2019	Prime minus 1.86%	7.72

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

8. Derivative Financial Instruments (continued)

After giving effect to the above derivative transactions, the Indiana University Health System's variable-rate debt was approximately 11.4% and 11.1% of total debt outstanding as of December 31, 2013 and 2012, respectively.

In addition, long-term basis swap arrangements were entered into for the purpose of managing the effect of interest rates on cash flows and were in place as of December 31, 2013, as follows:

Notional Amount	Effective Date	Maturity Date	Swap Type	Rate Received	Rate Paid
\$ 140,446	3/10/2021	2/15/2033	Forward Starting	75.00% three-month LIBOR minus 0.05%	SIFMA
175,407	1/04/2008	2/15/2033	Basis	75.00% one-month LIBOR	SIFMA
175,407	2/15/2009	2/15/2021	Basis	72.00% three-month LIBOR minus 0.13%	SIFMA
309,200	3/10/2021	1/07/2033	Forward Starting	75.00% three-month LIBOR minus 0.04%	SIFMA
309,200	3/07/2009	3/07/2021	Basis	72.00% three-month LIBOR minus 0.12%	SIFMA
309,200	6/07/2011	1/07/2033	Basis	75.00% one-month LIBOR	SIFMA
250,000	3/01/2009	9/30/2038	Basis	77.00% three-month LIBOR minus 0.11%	SIFMA
250,000	3/01/2009	9/30/2038	Basis	77.00% three-month LIBOR minus 0.11%	SIFMA

Guidance on fair value accounting stipulates that a credit valuation adjustment (CVA) should be applied to the mark-to-market valuation position of interest rate swaps to more closely capture the fair value of such instruments. Collateral arrangements reduce the credit exposure and are considered in determining the CVA. As of December 31, 2013, the fair value of interest rate swaps was a liability of \$139,072, which is net of CVA of \$23,830. As of December 31, 2012, the fair value of interest rate swaps was a liability of \$165,923, which is net of CVA of \$33,378. The fair values of the swaps have been included with noncurrent liabilities in the accompanying consolidated balance sheets.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

8. Derivative Financial Instruments (continued)

As of December 31, 2013, interest rate swaps had a total notional amount of \$1,934,883, including \$465,668 of fixed-pay swaps and \$1,469,215 of basis swaps. Under agreements executed with counterparties, Indiana University Health is obligated to fund collateral amounts when the aggregate market value of swaps with a given counterparty exceeds a threshold set forth in the related agreement. The aggregate fair value of all derivative instruments, consisting of fixed-pay and basis swaps, with credit-risk-related contingent features that are in a liability position on December 31, 2013 and 2012, was \$146,194 and \$169,006, respectively. No collateral was posted as of December 31, 2013 and 2012.

The Indiana University Health System recorded the following gains (losses), within nonoperating income and losses, in the accompanying consolidated statements of operations and changes in net assets related to these derivative financial instruments:

	Year Ended December 31	
	2013	2012
Gains (losses) on interest rate swaps, net:		
Unrealized gains on interest rate swaps	\$ 26,851	\$ 32,294
Realized losses on interest rate swaps	(15,472)	(15,240)
	<u>\$ 11,379</u>	<u>\$ 17,054</u>

9. Fair Value Measurements

The accounting guidance for the application of fair value provides, among other matters, for the following: defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and establishes a framework for measuring fair value; establishes a three-level hierarchy for fair value measurements based upon the observability of inputs to the valuation of an asset or liability as of the measurement date; requires consideration of nonperformance risk when valuing liabilities; and expands disclosures about instruments measured at fair value. The three-level hierarchy is based upon the nature of valuation techniques and whether such techniques are based upon observable or unobservable inputs, as defined.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

9. Fair Value Measurements (continued)

Observable inputs are intended to reflect market data obtained from independent sources, while unobservable inputs may reflect market assumptions made by management or measurements made by financial specialists generally associated with the financial asset or liability. These two types of inputs create the following fair value hierarchy:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities as of the reporting date.
- Level 2 – Pricing inputs other than quoted prices included in Level 1 that are either directly observable or that can be derived or supported from observable data as of the reporting date.
- Level 3 – Pricing inputs include those that are significant to the fair value of the financial asset or financial liability and are not observable from objective sources. In evaluating the significance of inputs, the Indiana University Health System generally classifies assets or liabilities as Level 3 when their fair value is determined using unobservable inputs that, individually or when aggregated with other unobservable inputs, represent more than 10% of the fair value of the assets or liabilities. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

The following tables set forth by level within the fair value hierarchy the Indiana University Health System's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2013 and 2012. The financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The assessment of the significance of a particular input to the fair value measurement requires judgment, could be subject to change or variation, and may affect the valuation of fair value assets and liabilities and their classification within the fair value hierarchy levels.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

9. Fair Value Measurements (continued)

	Level 1	Level 2	Level 3	Total
December 31, 2013				
Assets				
Cash and cash equivalents	\$ 395,635	\$ –	\$ –	\$ 395,635
Trading securities:				
U.S. government and agency obligations	274,950	27,593	–	302,543
U.S. corporate obligations	152,682	407,395	–	560,077
U.S. equity securities	433,279	5,039	–	438,318
Non-U.S. securities	126,776	368,586	–	495,362
Real estate investment trusts and other	5,589	2,897	–	8,486
Beneficial interests in charitable remainder and perpetual trusts	–	10,107	–	10,107
Total assets measured at fair value on a recurring basis	<u>\$ 1,388,911</u>	<u>\$ 821,617</u>	<u>\$ –</u>	<u>\$ 2,210,528</u>
Liabilities				
Interest rate swaps	\$ –	\$ –	\$ 139,072	\$ 139,072
Total liabilities measured at fair value on a recurring basis	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 139,072</u>	<u>\$ 139,072</u>
December 31, 2012				
Assets				
Cash and cash equivalents	\$ 543,923	\$ –	\$ –	\$ 543,923
Trading securities:				
U.S. government and agency obligations	252,632	43,410	–	296,042
U.S. corporate obligations	161,651	355,426	–	517,077
U.S. equity securities	346,610	5,298	–	351,908
Non-U.S. securities	89,116	205,790	–	294,906
Real estate investment trusts and other	3,264	4,535	–	7,799
Beneficial interests in charitable remainder and perpetual trusts	–	9,192	–	9,192
Total assets measured at fair value on a recurring basis	<u>\$ 1,397,196</u>	<u>\$ 623,651</u>	<u>\$ –</u>	<u>\$ 2,020,847</u>
Liabilities				
Interest rate swaps	\$ –	\$ –	\$ 165,923	\$ 165,923
Total liabilities measured at fair value on a recurring basis	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 165,923</u>	<u>\$ 165,923</u>

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

9. Fair Value Measurements (continued)

The fair value of cash and cash equivalents, which consist mainly of funds invested in money market funds, is based on quoted market prices and classified as Level 1. The fair value of Level 1 trading securities is based on quoted market prices from an active exchange. The fair value of Level 2 trading securities is based on third-party market quotes in an inactive market or similar securities in an active market and other observable inputs. The fair value of interest rate swaps is based upon forward interest rate curves, as adjusted for CVA (see Note 8).

Cash and cash equivalents not held in money market funds aggregated \$111,532 and \$134,880 as of December 31, 2013 and 2012, respectively, and are not included in the tables. The Indiana University Health System's \$759,963 and \$541,648 of alternative investments as of December 31, 2013 and 2012, respectively, are not included in the tables because they are accounted for using the equity method of accounting (see Note 5). The beneficial interests in charitable remainder and perpetual trusts are shown within other long-term assets on the accompanying consolidated balance sheets.

The following table is a rollforward of the amounts included in the consolidated balance sheets for financial instruments classified within Level 3 of the valuation hierarchy defined above:

	Financial Liabilities for Derivative Financial Instruments
Fair value at January 1, 2013	\$ 165,923
Unrealized gains	(26,851)
Fair value at December 31, 2013	<u>\$ 139,072</u>

Due to the significance of the CVA relative to the fair value of the swaps, whose inputs are not observable from objective sources, interest rate swaps are classified as Level 3 instruments. The Indiana University Health System engages a third party to assist in valuing the CVA. The CVA adjusts the fair value of each swap based on the credit risk of the party holding the swap in a liability position at that point in time. This credit risk is measured by taking the spread between

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

9. Fair Value Measurements (continued)

the AAA-rated Municipal General Obligation (Muni GO) curve and the AA-rated Municipal Healthcare curve (or the AA+ rated Muni GO curve for the swaps insured by Assured Guaranty Municipal Corporation) and adjusting that spread to a taxable basis using the relevant SIFMA/LIBOR ratio. A credit risk adjusted mark-to-market is then calculated by adding the relevant taxable spread to the LIBOR swap curve and revaluing the swap using the adjusted curve.

The value of the CVA may vary depending upon the following factors:

- whether the Indiana University Health System is required to post collateral under the swap agreements,
- to the extent that the credit rating of the Indiana University Health System increases or decreases, in which case the CVA would decrease or increase, respectively (assuming the swaps are in a liability position), or
- to the extent that the spread between the swap curves discussed above expands or compresses.

Generally, swaps are transferred between Level 2 and Level 3 when the CVA exceeds 10% of the gross valuation of the swap. Transfers are generally recorded at the end of the reporting period. There were no material transfers between Level 1 and Level 2.

10. Commitments and Contingencies

The Indiana University Health System is from time to time subject to various legal proceedings and claims arising in the ordinary course of business. The Indiana University Health System's management does not expect that the outcome in any of its currently ongoing legal proceedings or the outcome of any other claims, individually or collectively, will have a material adverse effect on the Indiana University Health System's financial condition, results of operations, or cash flow.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

10. Commitments and Contingencies (continued)

Leases

Buildings and medical and office equipment are leased under noncancelable operating and capital leases. Future minimum lease payments as of December 31, 2013, are as follows:

	Operating Leases	Capital Leases
Year ending December 31:		
2014	\$ 49,349	\$ 15,326
2015	38,991	13,047
2016	32,942	9,893
2017	26,743	8,382
2018	19,971	8,218
Thereafter	59,297	180,230
Total minimum lease payments	<u>\$ 227,293</u>	235,096
Less amount representing interest		126,612
Present value of net minimum lease payments		<u>\$ 108,484</u>

Rent and lease expense, included in supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets, amounted to \$74,376 and \$89,478 for the years ended December 31, 2013 and 2012, respectively.

11. Medical Malpractice

The Indiana University Health System's medical malpractice coverage is provided through a program of commercial insurance. The program of medical malpractice coverage considers limitations in claims and damages prescribed by the Indiana Medical Malpractice Act (the Act), which limits the amount of individual claims to \$1,250 and annual aggregate claims to \$7,500, of which up to \$1,000 would be paid by the State of Indiana Patient Compensation Fund (the Fund) and \$250 by the Indiana University Health System for each occurrence of malpractice. The Act also requires that health care providers meet certain requirements, including making funding payments to the Fund and maintaining certain insurance levels. The Indiana University Health System has met these requirements and is a qualified provider under the Act, retaining risk of \$250 per occurrence and \$7,500 in the annual aggregate.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

11. Medical Malpractice (continued)

The Indiana University Health System's medical malpractice program includes coverage offered by the captive insurance companies. Commercial insurance carriers also provide reinsurance for certain excess general liability coverage of the captive insurance companies on a claims-made basis (aggregating \$100,000).

Contributions for coverage provided by the captive insurance companies are expensed as incurred, and loss reserves are established for incurred but not yet reported claims. Laws in the jurisdictions in which the captive insurance companies are domiciled require, among other matters, that certain capital and funding requirements be met. The actuarially determined amount of accrued medical malpractice claims is included in noncurrent liabilities in the accompanying consolidated balance sheets.

12. Retirement Plans

Defined-Contribution Plans

Retirement benefits are provided to substantially all employees of the Indiana University Health System, primarily through defined-contribution plans. Contributions, which are included in benefits expense, to the defined-contribution plans are based on compensation of qualified employees and amounted to \$89,279 in 2013 and \$89,833 in 2012 (net of forfeitures of \$3,202 and \$2,547 in 2013 and 2012, respectively).

Defined-Benefit Plans

Defined-benefit pension plans sponsored by Indiana University Health, LaPorte, Ball Memorial, and Bloomington have been curtailed, with benefits generally frozen or limited, or no new participants are allowed. The defined-benefit pension plans applicable to Indiana University Health were principally limited to current and former employees who elected not to participate in the defined-contribution plan established at the time of Indiana University Health's formation and current and former executives who participated in a supplemental employee retirement plan of Indiana University Health.

Pension benefits are based on years of service and compensation of employees (as defined) and are actuarially determined. Where applicable, the funding policy is to annually contribute the contribution required to comply with applicable legislation and IRS regulations.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

12. Retirement Plans (continued)

Adjustments to pension liabilities to reflect funded status are charged or credited to unrestricted net assets. A decrease to the pension liability of \$130,488 has been recorded in 2013 due to contributions of \$61,863 and higher discount rates assumed for net periodic pension costs and benefit obligation.

The following table sets forth the funded status of the defined-benefit pension plans and amounts recognized in the consolidated financial statements as of and for the years ended December 31, 2013 and 2012. The discount rates used vary with each plan based on plan characteristics such as the average age of participants.

	2013	2012
Changes in benefit obligation of the plans:		
Benefit obligation at beginning of year	\$ 498,114	\$ 438,884
Benefit obligation as of January 1, 2012, IUHP	—	8,691
Benefit obligation at the beginning of the year, as adjusted	498,114	447,575
Service cost and other	1,872	2,191
Interest cost	19,991	21,601
Actuarial (loss) gain	(46,819)	51,738
Benefits paid	(26,405)	(24,991)
Benefit obligation at end of year	<u>\$ 446,753</u>	<u>\$ 498,114</u>
Changes in assets of the plans:		
Fair value of assets at beginning of year	\$ 343,634	\$ 299,882
Actual return on assets	43,669	30,992
Employer contributions	61,862	37,751
Benefits paid	(26,405)	(24,991)
Fair value of assets at end of year	<u>\$ 422,760</u>	<u>\$ 343,634</u>
Funded deficiency at December 31	<u>\$ (23,993)</u>	<u>\$ (154,480)</u>
Items not yet recognized as a component of net periodic pension cost:		
Net actuarial loss	\$ 79,847	\$ 166,217
Prior service cost	—	(314)
	<u>\$ 79,847</u>	<u>\$ 165,903</u>

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

12. Retirement Plans (continued)

	2013	2012
Components of net pension benefit cost:		
Service cost	\$ 1,957	\$ 2,191
Interest cost	19,991	21,601
Expected return on assets	(23,512)	(22,927)
Amortization of unrecognized prior service cost	(314)	(283)
Amortization of unrecognized net loss	19,327	14,837
Amortization of transition obligation	—	80
Termination benefit and settlement (income) expense	(85)	886
Net periodic pension cost	<u>\$ 17,364</u>	<u>\$ 16,385</u>
Weighted-average actuarial assumptions to determine benefit cost:		
Discount rate for net periodic pension cost	4.04%	4.90%
Discount rate for benefit obligations	4.91	4.10
Expected rate of return on plan assets	6.47	6.83
Rate of compensation increase	2.00	2.50
Accumulated benefit obligation	\$ 437,638	\$ 488,188
Fair value of assets at end of year	<u>422,760</u>	<u>343,634</u>
Accumulated benefit obligation exceeding fair value of plan assets	<u>\$ 14,878</u>	<u>\$ 144,554</u>
Expected future benefit payments:		
2014		\$ 23,058
2015		24,445
2016		26,104
2017		27,580
2018		29,289
2019–2023		153,761

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

12. Retirement Plans (continued)

Accumulated adjustments to unrestricted net assets at December 31, 2013, include amounts related to net actuarial loss and prior service costs that have not yet been recognized in net pension benefit cost. Expected amortization of amounts in unrestricted net assets is expected to increase net periodic pension costs by \$4,613 during the year ending December 31, 2014. Contributions are expected to aggregate \$581 to the defined-benefit pension plans during 2014.

The principal long-term determinant of a plan's investment return is its asset allocation. The plans' allocations are weighted toward growth-oriented assets versus duration-oriented investments. The expected long-term rate of return assumption is based on the mix of assets in the plans, the long-term earnings expected to be associated with each asset class, and any additional return expected through active management. These assumptions are periodically benchmarked against peer plans.

The weighted-average asset allocations of the plans at December 31, by asset category, are as follows:

	2013	2012
Asset category		
U.S. corporate obligations	30%	18%
U.S. equity securities	25	29
Non-U.S. securities	22	20
Hedged strategy (fund of funds)	20	20
Cash and cash equivalents	3	3
U.S. government and agency obligations	–	9
Real estate investment trusts and other	–	1
	100%	100%

The allocation strategy for the plans is currently composed of approximately 60% to 70% of growth-oriented investments and 30% to 40% of duration-oriented investments. The largest component of these growth-oriented assets is public equity securities that are diversified and invested in U.S. and international companies.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

12. Retirement Plans (continued)

The following tables present the plans' financial instruments as of December 31, 2013 and 2012, measured at fair value on a recurring basis within the fair value hierarchy as disclosed in Note 9:

	Level 1	Level 2	Level 3	Total
December 31, 2013				
Assets				
Cash and cash equivalents	\$ 14,440	\$ –	\$ –	\$ 14,440
U.S. corporate obligations	126,810	7	–	126,817
U.S. equity securities	106,894	–	–	106,894
Non-U.S. securities	42,553	48,813	–	91,366
Hedged strategy (fund of funds)	–	83,243	–	83,243
Total assets measured at fair value on a recurring basis	\$ 290,697	\$ 132,063	\$ –	\$ 422,760
December 31, 2012				
Assets				
Cash and cash equivalents	\$ 12,375	\$ –	\$ –	\$ 12,375
U.S. government and agency obligations	18,364	12,709	–	31,073
U.S. corporate obligations	33,415	29,881	–	63,296
U.S. equity securities	97,806	686	–	98,492
Non-U.S. securities	50,885	18,424	–	69,309
Hedged strategy (fund of funds)	–	67,192	–	67,192
Real estate investment trusts and other	1,897	–	–	1,897
Total assets measured at fair value on a recurring basis	\$ 214,742	\$ 128,892	\$ –	\$ 343,634

The fair value of cash equivalents, which consist mainly of funds invested in money market funds, is based on quoted market prices and classified as Level 1. The fair value of Level 1 investments is based on quoted market prices from an active exchange. The fair value of Level 2 investments is based on third-party quotes in an inactive market or similar securities in an active market and other observable inputs.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

12. Retirement Plans (continued)

The plans invest in alternative investments for which the net asset value per share represents the fair value of the investment held. Risks and redemption restrictions for these investments are similar to the alternative investments described in Note 5.

13. Endowments

Endowment funds of Methodist Health Foundation and BMH Foundation consist of donor-restricted endowment funds held for various specific purposes. As required by GAAP, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

The Board of Directors of both foundations have interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the foundations classify as permanently restricted net assets the following: (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the foundations in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the foundations consider the various factors in making a determination to appropriate or accumulate donor-restricted endowment funds, such as the duration and preservation of the fund, the purposes of the foundations and the donor-restricted endowment fund, general economic conditions, the possible effect of inflation and deflation, the expected total return from income and the appreciation of investments, other resources of the organization, and the investment policies of the foundations.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

13. Endowments (continued)

Changes in and composition of donor-restricted endowment net assets for both foundations for the years ended December 31, 2013 and 2012, were as follows:

	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets at			
January 1, 2012	\$ 9,288	\$ 44,679	\$ 53,967
Investment return	5,031	227	5,258
Appropriation of endowment assets for expenditures	(3,379)	—	(3,379)
Endowment net assets at			
December 31, 2012	10,940	44,906	55,846
Investment return	5,477	244	5,721
Appropriation of endowment assets for expenditures	(1,782)	—	(1,782)
Endowment net assets at			
December 31, 2013	\$ 14,635	\$ 45,150	\$ 59,785

In 2012, Methodist Health Foundation and BMH Foundation transferred a total of \$600 from temporarily and permanently restricted net assets back to unrestricted net assets as a result of a 2011 transfer from unrestricted net assets to maintain donor-restricted endowment funds at the level required by the donor stipulations or law. In 2013, Methodist Health Foundation and BMH Foundation transferred \$362 from unrestricted net assets to temporarily restricted net assets to maintain donor-restricted endowment funds at the level required by the donor stipulations or law.

Methodist Health Foundation and BMH Foundation have adopted separate investment and spending policies for endowment assets. Policies for both foundations attempt to preserve capital, maximize the return within reasonable and prudent levels of risk, and provide a return to the restricted funds. Endowment assets are invested in a manner that is intended to produce results that exceed the initial recorded value of the investment and yield a targeted long-term rate while assuming a moderate level of investment risk. Distributions are made for the purposes of supporting various Indiana University Health and Ball Memorial program services. Each foundation has set a threshold for the amount available to distribute each year.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

14. Related-Party Transactions

Indiana University School of Medicine

The Consolidation Agreement requires that Indiana University Health fund salaries and related employee benefit costs for medical doctor interns and residents of the School of Medicine who provide services at the Indiana University Health System's facilities. These costs totaled \$43,862 and \$41,307 in 2013 and 2012, respectively, and have been reported with salaries, wages, and benefits expense in the accompanying consolidated statements of operations and changes in net assets.

The Consolidation Agreement also provides for additional support to the School of Medicine to recognize, as a result of the consolidation, the enhanced and increased level of services being provided, including services to the medically indigent through medical education and research. During 2013 and 2012, Indiana University Health expensed \$50,000 and \$52,610, respectively, related to educational and research support provided to the School of Medicine. As of December 31, 2013, \$40,000 of this support was recorded within accounts payable and accrued expenses in accompanying consolidated balance sheets and paid to the School of Medicine during the first quarter of 2014. The School of Medicine rents space at Indiana University Health's Fairbanks Hall, an educational and resource center, under a 34-year lease agreement with Indiana University Health. In 2008, the School of Medicine prepaid the rent, totaling \$4,887 under the agreement, and the income is being recognized over the term of the lease.

The Indiana University Health System purchases certain services from the School of Medicine. These expenses, principally for medical care case management services, utilities, laboratory services, and other services, totaled \$18,872 and \$19,030 for the years ended December 31, 2013 and 2012, respectively, and have been reported with supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets.

In 2012, Indiana University Health committed to support ratably for a five-year period ending December 31, 2016, certain basic, clinical, and translational research programs of the School of Medicine. The total commitment aggregates \$75,000, subject to Board approval annually, and will be used to reimburse expenses incurred by the School of Medicine. For the years ended December 31, 2013 and 2012, the Indiana University Health System expensed \$15,000 under this agreement within supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets, of which \$22,138

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

14. Related-Party Transactions (continued)

and \$13,981 was accrued within accounts payable and accrued expenses at December 31, 2013 and 2012, respectively. Additionally, in 2012, the Board approved research grants in the amount of \$5,000, which was expensed through purchased services in the accompanying consolidated statement of operations and changes in net assets.

During 2012, IUHP received a grant from Indiana University Medical Group Foundation in the amount of \$45,000 to be used toward physician recruitment and transition for the purpose of expanding access to care to Medicaid and other underserved patient populations. As the grant restrictions were met as of December 31, 2012, the \$45,000 was recorded as other operating revenue in the accompanying consolidated statement of operations and changes in net assets in 2012.

Other Foundations

Bloomington Hospital Foundation, Tipton County Foundation, Indiana University Health White Memorial Hospital Foundation, and White County Community Foundation are tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code; these foundations hold funds solely on behalf of Bloomington, Tipton, and White, respectively.

The financial statements of these foundations are not included in the consolidated financial statements. The interests in net assets of these other foundations, which totaled \$13,579 and \$12,898 at December 31, 2013 and 2012, respectively, are included with other assets and net assets in the accompanying consolidated balance sheets and principally represent donor-restricted funds. These foundations also hold other net assets that are subject to the direction of their respective Boards of Directors. Other changes in the net assets of these foundations are generally reflected within temporarily and permanently restricted net assets.

15. Health Care Legislation and Regulation

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, participation requirements, reimbursement for patient services, Medicare and Medicaid fraud and abuse, and security, privacy, and standards of health information. Government activity has continued with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and noncompliance with regulations

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)
(Thousands of Dollars)

15. Health Care Legislation and Regulation (continued)

by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs together with the imposition of significant fines and penalties, significant repayments for patient services previously billed, and disruptions or delays in processing administrative transactions, including the adjudication of claims and payment.

In the opinion of management, there are no known regulatory inquiries that are expected to have a material adverse effect on the consolidated financial statements of the Indiana University Health System; however, compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

The Affordable Care Act and the Health Care and Education Reconciliation Act legislation, among other matters, is designed to expand access to coverage to substantively all citizens by 2019 through a combination of public program expansion and private industry health insurance. Changes to existing Medicare and Medicaid coverage and payments are also expected to occur as a result of this legislation. Implementing regulations are generally required for these legislative acts, which are to be adopted over a period of years, and accordingly, the specific impact of future regulations is not determinable.

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